



Research Paper

## Investigating the Effect of Market Efficiency on the Relationship between the Rate of Return and the Future Profitability of Firms<sup>1</sup>

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### INTRODUCTION

Fama (1970) proposed the concepts of weak and semi-strong market efficiency, but the primary drivers of stock price fluctuations have received less attention. Furthermore, whether stock prices with higher market efficiency scores more accurately predict future profitability remains underexplored. Future earnings are a key factor in valuation models— if prices accurately reflect the company's future financial performance, assuming other factors remain constant, they align with the company's intrinsic value. This research highlights the role of market efficiency as a variable in the relationship between stock returns and future profitability. The study aims to determine the effect of market efficiency on this relationship among companies listed on the Tehran Stock Exchange. Market efficiency, a latent variable, is represented by various indicators. Aggregating these indicators reduces measurement error and provides a more accurate representation of overall market performance than analyzing individual indicators separately.

### MATERIALS AND METHODS

To achieve the research objectives, 94 companies listed on the Tehran Stock Exchange between 2013 and 2022 were selected using systematic elimination sampling. The regression method was employed to test the research hypotheses. To measure market efficiency, instead of using individual indicators, a composite index was created through principal components analysis (PCA). This index encompasses multiple dimensions of market efficiency, providing a more robust metric for analysis.

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## RESULTS AND DISCUSSION

The findings of the first hypothesis reveal a significant relationship between future profitability and stock return rates. This suggests that shareholders in the capital market have relative awareness of future profits, which increases the likelihood of profitability and enhances stock returns. The results of the second hypothesis indicate that market efficiency moderates the relationship between future profitability and stock return rates. However, contrary to expectations, the market efficiency score does not improve the ability of stock prices to predict future profitability. Instead, the findings show that the relationship between profitability and stock return rates weakens when incorporating the composite efficiency score. For the third hypothesis, it was anticipated that higher current company value would correspond to expectations of greater future profitability. Although market efficiency was expected to strengthen this relationship, the results indicate that this effect is not significant, with a significance level of 0.3325 (above the 5% threshold). Thus, the third hypothesis is rejected.

## CONCLUSION

The results of the research demonstrate a positive relationship between stock returns and the ability to predict company profitability. However, market efficiency has not improved the relationship between company value and future profitability, nor has it strengthened the relationship between future profitability and stock return rates. Investors are encouraged to advocate for the stock exchange to establish rules and regulations that emphasize accurate share pricing and enhance market efficiency. Authorities of the stock exchange and securities organization are advised to implement robust regulatory frameworks to prevent market manipulation, insider trading, and other unethical practices that undermine market efficiency. Furthermore, leveraging technological advancements such as automation, artificial intelligence, and blockchain is recommended to streamline processes, reduce transaction costs, and improve market liquidity. Future researchers are encouraged to explore additional dimensions of market efficiency. By developing a rating system to identify indicators with the most significant impact on market efficiency, these findings can be shared with the stock exchange organization to guide necessary measures for improvement. It is also important to note that this study did not account for the effects of economic sanctions, inflation, and exchange rate changes in its hypothesis test models. These factors may influence the validity of the research and should be considered in future studies.

**Keywords:** Market efficiency, Rate of return, Future profitability.

**JEL Classification:** *G17, G12, G14.*

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